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Supreme Court of the United States

OCTOBER TERM, 1942.

No. 985

KRESGE DEPARTMENT STORES, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR CERTIORARI.

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Petition for Certiorari.

Supreme Court of the United States

OCTOBER TERM, 1942.

No. ....

KRESGE DEPARTMENT STORES, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The petition of Kresge Department Stores, Incorporated, respectfully shows:

A.

Summary Statement of the Matter Involved.

This case arose under the Personal Holding Company Surtax Statute: sec. 351 of the Revenue Act of 1934; c. 277, 48 Stat. 680, 751; 26 U. S. C. A. 331. Under that section the Commissioner determined deficiencies of $15,714.61 for the fiscal year which ended January 31, 1935, and $7,424.25 for the following fiscal year, as well as penalties of $3,928.65 and $1,856.06 for the respective years because of

failure to file personal holding company tax returns (R. 9-10).

In the words of the statute, a corporation is not a personal holding company unless "at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and gains from the sale of stock or securities". This case turns upon the words quoted. Although the Petitioner had upwards of 1,400 stockholders (R. 38), and its stock was listed and actively traded on the New York Stock Exchange (R. 17), more than 50% in value of the stock was owned during the years in question by not more than five individuals, thus meeting the other requirement of the statutory definition.

During the years in question the Petitioner received substantial sums ($61,720.73 and $32,759.42) as a result of operating a buying office in New York City (R. 24). If these sums are recognized as a part of gross income under section 351, then Petitioner is not a personal holding company, because less than 80% of its income, in each year, was derived from interest, etc. The Board of Tax Appeals held that the sums were a part of gross income and decided that Petitioner was not a personal holding company; that there were no deficiencies and no penalties. The decision of the Board was reversed by the Circuit Court of Appeals for the Third Circuit.

The New York City buying office was not operated for direct profit. With very minor exceptions, its services and facilities were used by four department stores located in Chicago, Washington, D. C., Newark, N. J., and Asbury Park, N. J. Through stock ownership the Petitioner was interested, during the years in question, in the corporations

which operated the Washington and Chicago stores. It had previously owned the capital stock of the corporation which operated the Newark store. Payments for services rendered by the buying office were made on a monthly basis to the Petitioner by the four stores. The total amount billed and paid was a sum equivalent to the total costs borne by the Petitioner in operating the buying office. The Asbury Park store paid $100 monthly. The other stores paid the balance of the total charged, the charge to each being a percentage based upon its gross sales in a previous year. The amount paid to the Petitioner by each store was not the exact cost of services rendered to that store by the buying office (R. 53), but the total amount paid by all four stores was equivalent to the total cost of operating the buying office (R. 23-24).

The New York City buying office of the Petitioner was a substantial enterprise. Between 25 and 30 persons were employed during the years in question, the majority of them being buyers. A place of business with approximately 11,000 square feet of floor space was maintained (R. 40-41). There was no store for the sale of goods, but there was a shipping room and storage room (R. 49-50). The primary service rendered by the Petitioner through its buying office was the purchase of goods in the New York market for the stores mentioned. Supplementary services were renderd, as described in the opinion of the Board (R. 22-23). The buying office furnished to the stores a common, conventional type of commercial service (R. 48). One of the corporate purposes of the Petitioner stated in its Certificate of Incorporation was "To act as * * * purchasing agent for domestic and foreign corporations * * *". From the be-

ginning, a main object of the Petitioner was to centralize buying power (R. 20). The New York City buying office had been in existence since 1923 (R. 40), and the business practices described were being followed long before the passage of the personal holding company tax statute. Efficient operation of the buying office benefited the Petitioner by benefiting the two store-operating companies in which it had an interest. Participation of the other two stores produced an advantage by adding purchasing power and reducing overhead (R. 53-54).

None of the store-operating companies had any stock interest in the Petitioner.

B.

Basis Upon Which It Is Contended That This Court Has Jurisdiction.

The statute concerning jurisdiction is Title 28, section 347 (a) of the United States Code, being the Act of February 13, 1925, c. 229, sec. 1, 43 Stat. 938. The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals by an order dated and filed January 12, 1943 (R. 111). On January 26, 1943 a petition for a rehearing was filed (R. 112). The order of the Court denying the petition for rehearing was filed March 17, 1943 (R. 120).

C.

The Questions Presented.

1. Was the Petitioner a personal holding company within the meaning of section 351 of the Revenue Act of 1934?

(a) In particular, were payments made to the Petitioner during the years in question by several department stores a part of "gross income" within section 351, those payments having been made for services rendered and facilities furnished to the stores by the Petitioner through its New York City buying office and the total of all amounts paid by the stores being equal to the costs of the Petitioner in operating the buying office?

2. Is the Petitioner properly subject to penalties for failure to file personal holding company returns (form 1120 H), even though corporation income and excess-profits tax returns (form 1120) were duly filed?

D.

Reasons Relied Upon for the Allowance of the Writ.

1. Conflicts between the decision of the Circuit Court of Appeals in this case and decisions of other circuit courts.

(a) One basis for the court's decision in this case is that the payments made by the stores to the Petitioner were not "gross income" of the Petitioner (R. 110). That holding is in conflict with a decision of the Court of Appeals of the Second Circuit in a case involving payments to a

corporation owning a cooperative apartment house. The "tenants" made payments to the corporation in a total amount equal to the expenses of the corporation. As in the present case, there was no profit or loss, but the payments of the "tenants" were recognized as income of the owning corporation. *Wood* v. *Rasquin,* 97 F. 2d 1023 (memo), affirming 21 F. Supp. 211.

(b) Another basis for the court's decision in this case is found in the following statement from the opinion (R. 110):

> "And a corporation cannot lift itself out of the class of personal holding company simply by causing non-personal holding company income to flow through its treasury, thereby increasing the amount of its gross income."

It has been expressly held by the Circuit Court of Appeals for the 8th Circuit that the personal holding company surtax statute must be literally applied. *Foley Securities Corp.* v. *Commissioner,* 106 F. 2d 731. There the literal application produced a result against the taxpayer. The language quoted above goes far beyond a literal application. It permits elements of gross income to be ignored, although the actual words of section 351 confer no such power.

(c) A very recent decision by the Circuit Court of Appeals for the 9th Circuit conflicts with the result of this case, and other cases, on the question of penalties. *Lane Wells Co., etc.* v. *Commissioner,* decided March 22, 1943. The opinion is not yet reported and is printed as an appendix to the brief accompanying this petition. There the regular corporation form 1120 was filed and it was held that there should be no penalties for failure to file the personal holding company form, 1120 H.

The Commissioner's ruling in the present case (affirmed by the Court) that the penalties automatically followed the failure to file personal holding company returns appears in the record at page 10. The corporation returns on form 1120, duly filed by the Petitioner, are in the record at pages 94 and 98.

2. The case presents an important question of federal law which has not been, but should be, settled by this Court. Are payments received for services rendered (or goods sold, etc.) a part of gross income when the total of the payments is equal to the expenses of the recipient? There are other reported cases which have dealt with this subject under the personal holding company surtax statute.

Andrew Jergens Co., 40 B. T. A. 868;
W. A. Bechtel Co., 42 B. T. A. 927;
General Management Corp., 46 B. T. A. 738;
Woodside Acres, Inc., 46 B. T. A. 1124.

The question is of special importance under the holding company statute, because the burden will be heavy and the hardship great when an operating company is unexpectedly subjected to the surtax.

The question is also of great importance at the present time because of the large number of cost-plus-a-fee war contracts in effect. Concerning such contracts the Income Tax Unit of the Treasury Department has issued a ruling (I. T. 3459, Cumulative Bulletin, 1941-1, p. 236) reading in part, (italics added)

> "In order clearly to reflect the net income, the gross income from the contract and from other contracts of this type, *including the so-called reimburse-*

> *ments of cost*, should be reported by the taxpayer (reporting on the accrual basis) in the returns for the taxable years in which income or expenses accrues, and there should be allowed as deductions therefrom the costs or expenses which are related to such gross income."

To place administrative practices on sound ground where the presently all important cost-plus contract is concerned, it should be finally determined whether payments made to a taxpayer to cover his costs are or are not gross income.

The alternative holding of the Court of Appeals, that a corporation cannot lift itself out of the personal holding company class simply by causing non-personal holding company income to flow through its treasury (R. 110) has been already mentioned. If that holding should be considered alone, it also presents an important question of federal law for review. Many corporations have stock so closely held as to meet the test of the statute. They also have income from royalties, dividends and interest. They are saved from the penal surtaxes of the statute by having income from operating sources. Is the statute to be so broadly construed as to make it possible to ignore the income from operating sources? That is a question of much importance.

Wherefore the Petitioner respectfully prays that a Writ of Certiorari be allowed to review the decision of the Circuit Court of Appeals for the Third Circuit.

KRESGE DEPARTMENT STORES, INCORPORATED

By WARD J. HERBERT,
Counsel for Petitioner.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. ....

KRESGE DEPARTMENT STORES, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

I. Opinions Below.

The opinion of the Board of Tax Appeals is reported in 44 B. T. A. 1210. The opinion of the Circuit Court of Appeals is not yet reported, but is printed at page 108 of the record.

II. Statement of the Case.

Section A of the petition contains a statement of facts, to which the Court is respectfully referred. That statement will only be supplemented here, particularly to show that the Petitioner's New York City buying office was an active and ordinary business enterprise rendering services for which it was entirely proper for the Petitioner to charge.

The employees of the office were Petitioner's employees, paid weekly by it. They were hired by Petitioner's manager, and supervised by him (R. 41 and 46). The major activity of the buying office was the purchasing of goods. The usual practice was for the seller to charge the price to the store whose purchase order was being filled. In numerous instances, however, where purchases were made by the New York office, sellers charged the Petitioner. Invoices were marked in evidence to furnish examples of purchases charged to the Petitioner, with the goods in question being subsequently resold to stores which were its clients or customers (R. 41-43). As found by the Board (R. 23), the New York office also did other things. It sought executive personnel for the stores, it sought special attractions, it surveyed weak departments and made recommendations for improvements (R. 43-45).

The scope and magnitude of the purchasing activities of Petitioner is indicated by the testimony (R. 54) that the use by the Newark store of the services of the New York buying office was alone responsible for adding a ten million dollar volume of purchasing power. In many cases, that extra ten million dollars of purchasing power operating through the New York buying office, made it possible to buy more advantageously for the benefit of the Chicago and the Washington stores, in which the Petitioner had a stock interest. The same effect of extra purchasing power was felt to a lesser extent in regard to the smaller store in Asbury Park. Consideration was given by the Petitioner to increasing the volume of the New York buying office by having others participate, and an effort was made to get other department stores interested (R. 54). At one time the

Fresno Dry Goods Store, which has no connection with the Petitioner made use of the services of the buying office (R. 48).

III. Argument.

The buying office of the Petitioner was not an artificial creation, but was an ordinary business enterprise. The Buyer's Manual of the National Retail Dry Goods Association (Rev. ed. 1937) says, in Chapter XXV, pages 341 *et seq.*:

> "Because of the importance of maintaining close contact with the New York market, department stores and specialty stores located outside New York City generally arrange for representation through what are known as resident buying offices. Some of the larger stores maintain their own offices in New York, with staffs of merchandise specialists, but the average-size department or specialty store finds it more economical to operate through a buying office which represents a number of non-competing stores."
>
> * * * * * *
>
> "To maintain an individual New York buying office is relatively more expensive, however, than to obtain resident buying service from an office that serves other non-competing stores. Moreover, since the buying power of even the larger department stores, when considered in terms of individual departments, is more restricted than the buying power of a group of stores, it is obvious that in some lines an individual store operating its own New York office cannot buy to the same advantage as can a group of stores operating through the same office."

The same work confirms that a fee based on sales volume (as in the present case) is common, by stating (p. 342):

> "Then there are the independent resident buyers, who provide New York market service for numerous department and specialty stores located outside New York City. These independent offices usually charge their subscribing stores an annual fee, the amount of which varies with the annual sales volume of the individual store."

The conduct of Petitioner's buying office was ordinary in all respects, except for the absence of direct profit. The case squarely presents the question of whether charges made to cover costs are gross income. The reasons for reviewing that question are mentioned in the petition.

The opinion of the Circuit Court indicates certain material misapprehensions of fact.

This statement appears in the opinion (R. 110),

> "Neither was it [Petitioner] in the business of performing services for compensation."

If this could be construed as an observation that Petitioner did not charge the various stores enough to realize a profit on the services and facilities furnished by the New York City buying office, then it would be correct. But Petitioner was very definitely in the business of performing services for compensation to the extent of being compensated sufficiently to cover the cost of those services. The question in the case is whether that "compensation" was gross income.

This statement about the Petitioner also appears in the opinion (R. 110):

> "Even the stores in which it had no direct financial interest were supplied with merchandise at its gross cost—without profit to taxpayer and without loss to it. All of the purchasing stores were billed directly and immediately for that part of the gross cost of the goods which represented purchase price. That this amount did not constitue part of taxpayer's gross income is unquestioned. It is our opinion that the part of gross cost representing taxpayer's operating expenses is—under the circumstances of this case—in exactly the same category as that representing purchase price. The impracticality of charging expenses to each lot of merchandise does not make income what would otherwise not be."

This indicates an impression that the Petitioner customarily bought goods, paid for them and then billed the stores for the purchase price. The facts were otherwise. The Petitioner merely acted as a purchasing representative for the stores. The work of locating and selecting goods, etc., was done by Petitioner, but the sales were made to the stores and the stores paid the purchase price, not to the Petitioner, but to the vendor. Such payments of purchase price were of course no part of Petitioner's gross income. In some instances, the Petitioner did buy merchandise in its own name and resold it to the stores at amounts equal to the cost.

It is true that "The impracticality of charging expenses to each lot of merchandise does not make income what would otherwise not be." Yet if payments equalling costs,

without profit, are gross income, they are no less gross income because charged monthly, instead of being charged when each specific service is rendered.

No tax evasion scheme is involved in this case. No such contention has ever been made by the Commissioner or any representative of the Treasury Department. The Petitioner is not a corporation which was at one time subject to the statute and later sought to escape by changed practices. When Petitioner was formed in 1923 (Exhibit P-4, R. 102) central buying for a group of stores was an essential element of the plan. The New York City buying office came into existence then, many years before Congress even thought of a personal holding company tax.

Without a basis in fact the circuit court suggested a tax evasion scheme when it said (R. 110) that "a corporation cannot lift itself out of the class of personal holding company simply by causing non-personal holding company income to flow through its treasury—" and it stated an unsound proposition of law which should be reviewed. A correct statement would be this: In the absence of a plain tax evasion device which should be ignored by the Commissioner and the courts, any corporation which would otherwise be a personal holding company under the statute, will not be one if more than 20 per cent of its gross income is derived from sources other than royalties, dividends, interest, annuities, and gains from the sale of stock or securities. Aside from these specified sources, where the money comes from and how it is received are immaterial questions.

Charges like those made by the Petitioner, which are a part of sound commercial practice, should be recognized

as gross income when paid, even though the charges are equal to costs. In this connection the Court is respectfully urged to consider the reasoning of the Board of Tax Appeals in the *Andrew Jergens Company* case, 40 B. T. A. 868, and the *Bechtel Company* case, 42 B. T. A. 927.

There is no question in the present case about the independent legal obligations which arose as the result of the activities of the New York office of the Petitioner. Many purchases made in the name of the Petitioner followed by subsequent resales to others, are examples of this. The Petitioner hired and paid its own employees. Sellers of goods and employees looked to the Petitioner to satisfy its obligations just as the Standard Oil Company looked to the taxpayer in the *Bechtel* case. If a member of the buying staff of the Petitioner had committed a tort in the course of his employment, the Petitioner would have been liable to the injured party. In short, the Petitioner, to a greater degree than the taxpayers in the *Bechtel* and *Jergens* cases, carried on during the years in question a vigorous, extensive, independent activity through its own employees, as the result of which it received approximately $60,000 in one year and approximately $30,000 in the first five months of the following year. The sums should be included in the Petitioner's "gross income", thereby taking the Petitioner out of the operation of Section 351.

Section 351 of the Revenue Act of 1934 was not intended to apply to such companies as the Petitioner. The section was aimed at the "incorporated pocketbook". (H. R. 704—73rd Cong., 2d Sess.)

It is obvious that a corporation organized long before the statute, with operating rather than holding purposes

expressed in its charter, with 1400-1600 stockholders, with its stock listed and actively traded on the New York Stock Exchange and with a large and active office in New York City employing 25-30 people, the functions of this New York office being the handling of a great volume of commercial transactions having nothing to do with the owning and holding of stocks or notes, is not "an incorporated pocketbook" designed merely to accumulate a personal fortune and therefore is not within the field which Congress meant to cover by the statute.

The intent of the statute was not given sufficient weight by the Circuit Court of Appeals. The statute is penal in nature. It is of great importance to many corporations that the scope of its application be defined.

It is respectfully submitted that the Writ of Certiorari should be allowed.

WARD J. HERBERT,
Counsel of Petitioner.

APPENDIX.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME [26 U. S. C. A. 22].

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interests, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES [26 U. S. C. A. 331].

* * * * * *

(b) *Definitions.*—As used in this title—

(1) The term "personal holding company" means any corporation (other than a corporation exempt from taxation under section 101, and other than a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, and other than a life-insurance company or surety company) if—(A) at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, * * *

LANE-WELLS COMPANY, a corporation, and TECHNICRAFT ENGINEERING CORPORATION

v.

COMMISSIONER OF INTERNAL REVENUE.

(U. S. Circuit Court of Appeals, Ninth Circuit, No. 10,183, March 22, 1943)

Upon Petition for Rehearing

Before: Denman, Haney and Healy, Circuit Judges.

The opinion filed in this case on February 10, 1943, is hereby withdrawn, and the following substituted therefor:

Denman, Circuit Judge:

The petitioning corporations seek a review of a decision of the United States Board of Tax Appeals, now Tax Court of the United States, sustaining respondent's determination of deficiencies and penalties on income surtax for the tax years 1934, 1935 and 1936 under the personal holding company income tax provisions of the Revenue Acts of 1934 and 1936.

On June 1, 1939, the Commissioner of Internal Revenue mailed to the Technicraft Engineering Corporation, transferor, and Lane-Wells Company (a Delaware corporation), transferee, respectively, notices asserting various tax deficiencies, including deficiencies in personal holding company surtax income and 25 percent penalties for failure to file personal holding company returns for the three tax years in question.

Both the transferor and the transferee duly filed petitions for review, upon which the Board entered its decisions against both, sustaining the deficiencies and penalties.

The cases are brought to this court by petitions for review filed by the transferor and transferee. Pursuant to

stipulation of the parties, this court ordered consolidation of the two appeals.

Petitioner Lane-Wells Company was formed in 1937 to take over the business of petitioner Technicraft Engineering Corporation and its affiliated companies. In 1937, following a reorganization in which Lane-Wells Company of Delaware acquired the stock of Technicraft, the latter conveyed all its assets to the Delaware corporation and was dissolved.

A. The validity of the returns as affecting the time limiting statutes and penalties. The Board found that Technicraft, in good faith, claimed in its returns that it was not a personal holding company. It found further that the returns, filed in due time, showed all the facts necessary for the respondent to compute the taxes as a personal holding company obligation.

However, the incomes were returned on Form 1120 for taxing corporations not holding companies, instead of Form 1120H for taxing holding company corporations. The Commissioner, upheld by the Board, drew the legal conclusion that such a return was "no return" whatsoever, and hence he was entitled to determine deficiencies thereon at any time,—here in 1939, over four years after the 1934 return and over three years after the 1935 return were filed. It is not questioned that the 1936 return was assessed within the statutory time limit. The Commissioner also determined penalties of 25 percent for each year on the theory that Technicraft had failed to file any returns and the penalties were upheld by the Board.

We do not agree that the returns are to be deemed not made. They started the running of the time for assessment.

Construing analogous statutes of limitation, the Supreme Court holds that where one kind of income taxpayer

in good faith files a return on a form provided for another kind of income taxpayer, which return discloses the facts upon which the Commissioner may compute the income tax actually due from the taxpayer, the return filed is a return which starts the running of the time within which the Commissioner may assess the tax. Germantown Trust Company, Trustee *v.* Commissioner, 309 U. S. 304, 307, 310. The pertinent language of the Supreme Court and the cases cited showing the principle to be long recognized are (p. 310),

"It cannot be said that the petitioner, whether treated as a corporation or not, made no return of the tax imposed by the statute. Its return may have been incomplete in that it failed to compute a tax, but this defect falls short of rendering it no return whatever. Zellerbach Paper Co. *v.* Helvering, 293 U. S. 172, 180 (79 L. Ed. 264, 55 S. Ct. 127, 14 AFTR 688); Commissioner *v.* Stetson & Ellison Co., 43 F. (2d) 553 (9 AFTR 121); United States *v.* Tillinghast, 69 F. (2d) 718 (13 AFTR 772); Mabel Elevator Co., 2 BTA 517; Abraham Werbelovsky, 8 BTA 442, 446; Estate of F. M. Stearns, 16 BTA 889; J. R. Brewer, 17 BTA 704."

See also, Denman *v.* Motter (D. Kan. 1930) 44 F. (2d) 648 (9 AFTR 428), where no form available and return made on plain paper.

We are unable to see any difference in principle between the Germantown decision and the instant case, where one of the class of income taxpayers called "holding companies" files, in good faith, a return on a form provided for companies not holding companies which discloses the facts necessary to compute the tax due from the holding company.

The Board attempts to distinguish the Germantown case on the ground that though both forms 1120 and 1120H are for income taxpayers under the income tax provisions of the Act of 1934, taxpayer used Form 1120 under a tax im-

posed on it under Title I of the Act, while taxpayer should have used Form 1120H under a tax imposed by Title IA. The attempted distinction is that the tax under Title I is a "separate and distinct tax" from the tax under Title IA. The distinguishing is not sound. In the Germantown case the fiduciary return on Form 1041 returns income which is for computing a separate and distinct tax either on the trustee or the beneficiary. The tax on either is as much a "separate and distinct tax" from that on "associations taxable as corporations" as are separate and distinct the taxes on holding companies and companies not holding companies. Both are income taxes imposed by the same Act. The Act makes the statute of limitations applicable alike to all classes of returns.

The Treasury Department in 1934 attempted to forestall the rule of the Germantown case, established in 1940, by incorporating in the Regulations providing Form 1120H for holding companies a similar erroneous conclusion of law. This conclusion of law is stated in the Regulations as, "However, since the surtax imposed under Title IA is a distinct and separate tax from those imposed under Title I, the making of a return under Title I will not start the period of limitation for assessment of the surtax imposed under Title IA." Art. 351-8, Treasury Regulations 86, promulgated under the Revenue Act of 1934.

The respondent's contention is that, despite the holding of the Germantown case, the contrary construction of the law placed in a regulation makes the construction of law a regulation within the regulatory power of the Secretary of the Treasury. The statement of the proposition answers it. It is the function of the courts and not the Secretary to determine the legal effect of his Regulations requiring the use of forms for different classes of taxpayers.

The limitation and penalty provisions of the Revenue Act of 1934 here in question are (28 U. S. C. A. §275, §276, §291, §311),

"§275. Period of Limitation upon Assessment and Collection

Except as provided in 276

(a) General Rule. The amount of income taxes imposed by this title shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * * *

§276. Same—Exceptions

(a) False Return or No Return. In the case of a false or fraudulent return with intent to evade a tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment at any time.

* * * * * *

§291. Failure to File Return

In case of any failure to make and file a return required by this title, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, 25 per centum of the tax shall be added to the tax, * * *."

"§311. (Transferee liability.) * * *

(b) Period of limitation—The period of limitation for assessment of any such liability of a transferee or fiduciary shall be as follows:

(1) In the case of the liability of an initial transferee of the property of the taxpayer,—within one year after the expiration of the period of limitation for assessment against the taxpayer; * * *."

The 1934 taxes were not assessed within the four years of §311, and Lane-Wells, transferee, is not liable for the tax

for that year. Nor is Technicraft liable for the 1934 and 1935 taxes, assessed more than the three years of §275 after its returns for those years.

Concerning the 1935 taxes, Lane-Wells claims that the Board could not hold it liable because of a stipulation that "Lane-Wells is liable as transferee for any taxes which may be found due from Technicraft." It contends that such a stipulation prevented the Board from holding it liable for a tax as transferee, after the statutory three year limit for assessing Technicraft. We do not agree. We are not required to determine whether the Commissioner has the power to waive any tax by stipulating that the time limited in the statute for assessment has passed, when it is apparent that it has not. Here the stipulation, while stating that the transferee is liable for the tax due from the transferor, does not state that it is not liable for a tax which was due from the transferor but no longer collectible from the transferor because of the three year statute of limitation. We hold that the Commissioner properly assessed against Lane-Wells, as transferee, a tax in the amount of that owed by Technicraft for the year 1935, though not assessable against the latter.

Since, under the Germantown decision, the good faith return of all facts necessary to compute a tax is a "return," though on a form for a different taxpayer, the Board erred in upholding the penalties determined by the Commissioner under §276 and §291 for the tax years 1934, 1935 and 1936.

B. Technicraft is a personal holding company and it and Lane-Wells, transferee, are liable for deficiencies assessed against Technicraft for the years 1935 and 1936.

Technicraft, a California corporation, with its principal office in Los Angeles, was organized in December 1932. Throughout the periods in controversy its entire stock was owned by W. G. Lane, W. T. Wells, and their wives. These four individuals also owned the entire stock of Lane-Wells

Company of California, Lane-Wells Company of Oklahoma, Lane-Wells Company of Texas, and Lane-Wells International, Inc. Lane and Wells were directors and officers of the various affiliated companies. Petitioners concede that Technicraft is liable for the tax as a holding company, unless they have maintained their burden of proof before the Board that the Commissioner erred in deciding that 80 percent of Technicraft's income in 1935 and 1936 was from "royalties" as defined in Treasury Regulations 94 promulgated for the Revenue Act of 1936, of which Art. 351-2 (1) provides,

"(1) Royalties. — The term 'royalties' includes amounts received for the use of or for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. * * *."

The Board held that the income taxed by the Commissioner was made up in large part from royalties as so defined. There was no segregation in the evidence of the amounts other than royalties, or proof that such other amounts exceeded 20 percent of the income. Since the evidence shows a very substantial portion of the income to be royalties and there is no segregation the finding of the Board that petitioners have not proved their negative, i. e., that the royalties did not equal 80 percent of the income, must be sustained.

Petitioners further contend that none of the income consisted of royalties, because—although it was so denominated in agreements with the held companies—there was a prior agreement between Technicraft and the companies that all that was to be paid by them to Technicraft was for engineering services. We assume there was testimony from which such an agreement might be inferred. Our review, however, is confined to the determination whether "there is substantial evidence to support the conclusion" of the

Board to the contrary. Helvering *v.* Kehoe, 309 U. S. 277, 279 (84 L. Ed. 751, 60 S. Ct. 549, 23 AFTR 1072). There is abundant such evidence.

Technicraft had patent rights in a perforator device known as the Mims patent, for shooting into oil bearing stratification or through oil well piping to free the flow of mineral oil or gas. The held companies were in the business of furnishing such perforator services. Technicraft made contracts with each of the held companies for the use of the Mims patent, for which each agreed to pay a "royalty" of 15 percent of its gross receipts. It was the moneys so denominated "royalties" which Technicraft received which it returned to the Treasury for 1935 and 1936, also stating them to be "royalties." In the royalty agreement with the Oklahoma and Texas companies it was provided,

"I. Definitions:

The term 'Perforators' shall be construed to mean not only the patent specifically mentioned hereinbefore, but also any and all inventions, applications, patents, and any continuations, divisions, and/or reissues thereof and whether in the nature of apparatus or processes which the Licensor (Technicraft) now owns or controls or which it may at any time during the life of this agreement own or control and which relate or are accessories to said Perforators. The term 'Patent Rights' shall be construed to embrace as a group all the patents and applications herein specified or referred to or implied. The term 'gross receipts' shall be construed to mean the total receipts derived in any manner whatsoever from the manufacture and/or use of any and all apparatus or processes covered by said Patent Rights without deductions of any kind or character.

* * * * * *."

"IV. Royalties:

The royalty payments on the Patent Rights herein licensed shall be fifteen percent (15%) of the gross receipts; minimum royalties shall be not less than Seven Hundred and Fifty Dollars ($750.00) per month.

* * * * * *."

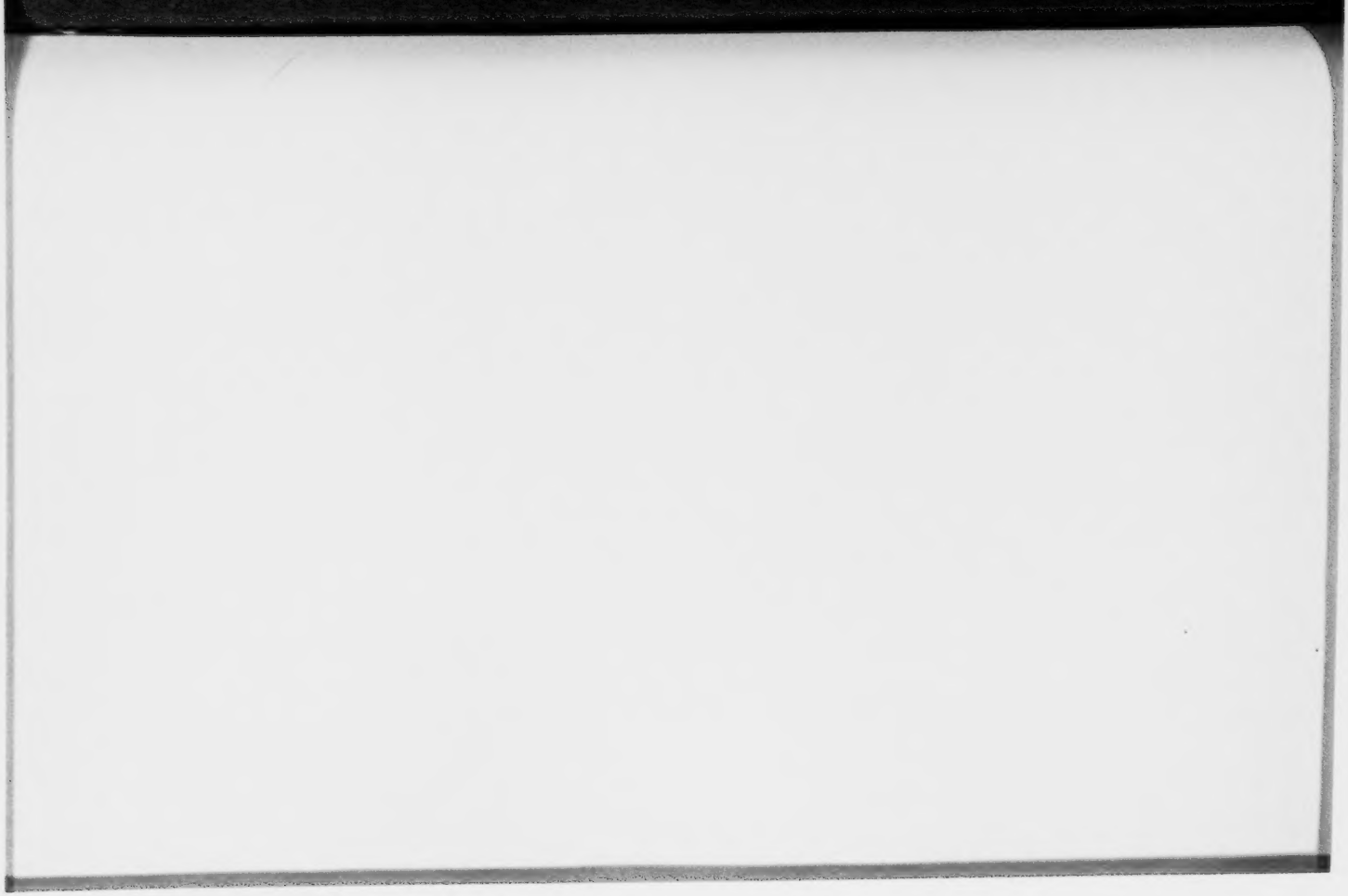
Technicraft conducted experiments, purchased test instruments, and built models of devices, some of which were sold to the Lane-Wells Company of California. Lane and Wells and employees of Technicraft assigned more than 50 patents to Technicraft. Technicraft owned at least 19 abandoned and unfiled inventions. In 1935 it had from 85 to 100 patents or patent applications which it was furnishing to the Lane-Wells companies by June 1, 1937, and of which seven or eight related to the basic principle of the Mims patent.

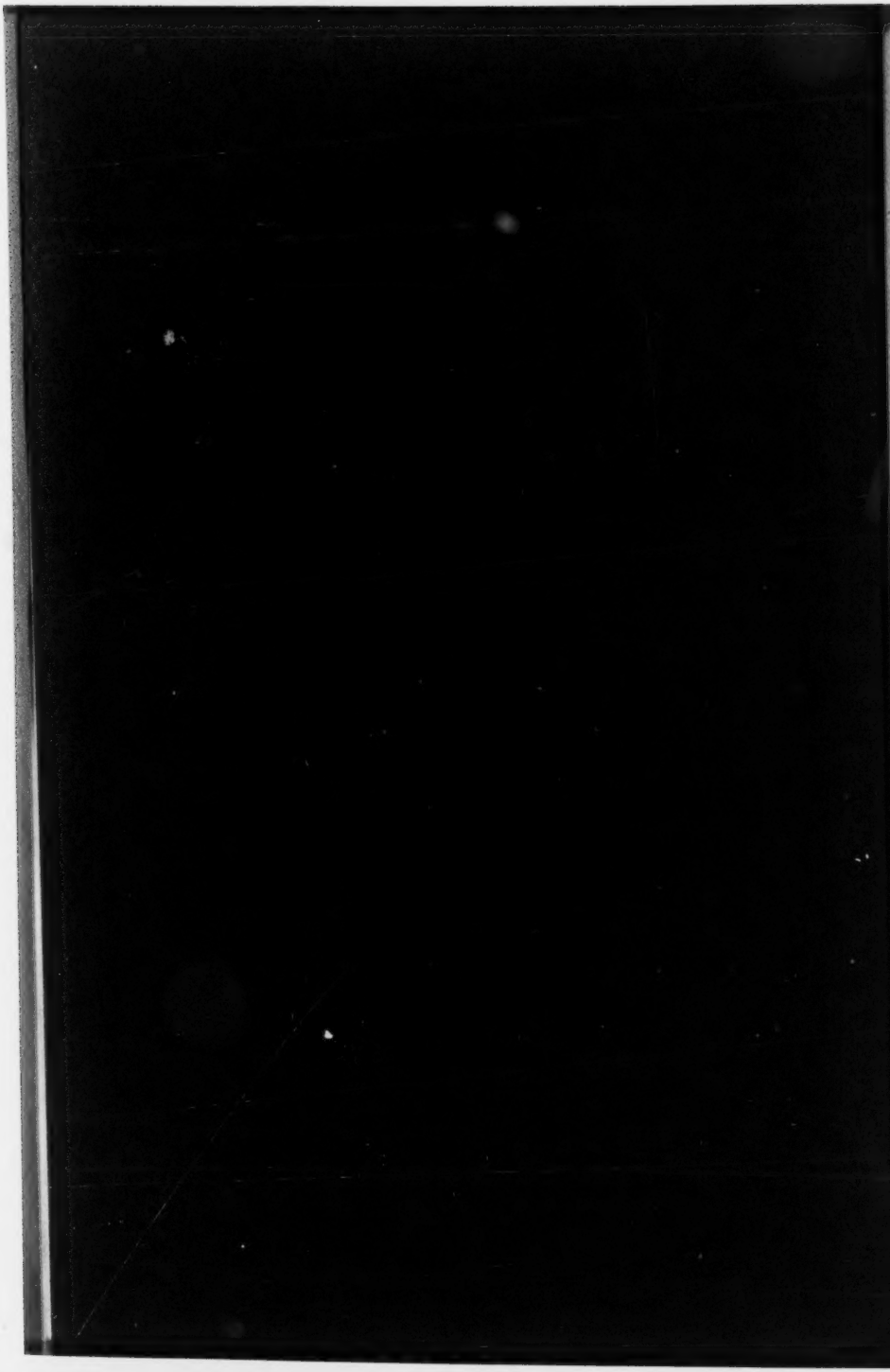
Obviously, the Board could reject the testimony of the prior agreements that the furnishing of these patents and models and mechanical devices or processes were mere professional engineering services paid for by the 15 percent of gross income. It could infer that the transactions were just what they were called, "licenses" to use the patents' models and devices upon which 15 percent of the gross income from their use constituted "royalties." As stated, if, in addition to the licensed matter, non-royalty devices were given for the same 15 percent consideration, there was no segregation to show that they amounted to over 20 percent of the taxed income. The Board properly decided that there were deficiencies in petitioners' income taxes for the years 1935 and 1936 in the amounts found in its decision.

Reversed and remanded for a recomputation of petitioners' income taxes for 1934, 1935 and 1936 in accord with this opinion.

Reversed and remanded.

The petition for rehearing is denied.





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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 985

KRESGE DEPARTMENT STORES, INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 19–28) is reported in 44 B. T. A. 1210. The opinion of the United States Circuit Court of Appeals (R. 108–111) is reported in 134 F. 2d 76.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 12, 1943 (R. 111). The petition for rehearing was denied on March 17, 1943 (R. 120). The petition for a writ of

certiorari was filed on May 1, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is a "personal holding company" within the terms of Section 351 (b) (1) (A) of the Revenue Act of 1934 because at least 80 per cent of its gross income for the taxable years was derived from dividends and interest. This depends upon whether certain amounts received by the taxpayer from a group of department stores in exact reimbursement for expenditures previously made by the taxpayer on behalf of the group of department stores constitute "gross income."

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved may be found in the Appendix, *infra,* pp. 11–13.

STATEMENT

The facts, as stipulated (R. 16–18) and as found by the Board of Tax Appeals (R. 20–24), may be summarized as follows:

The taxpayer is a Delaware corporation organized for the purpose of establishing one or more department stores and also to act as purchasing agent for domestic corporations (R. 20). It acquired all of the stock of several department stores in various cities; and in some instances

acquired part of the stock of department stores (R. 20–21).

For each of the fiscal years ended January 31, 1935, and January 31, 1936, more than 50 per cent in value of the taxpayer's stock was owned by not more than five individuals. During the taxable years involved the taxpayer did not own or operate a department store although, as previously stated, it did own stock in department store corporations. The taxpayer maintained in New York City a buying office which functioned for the direct benefit of four department stores, in three of which the taxpayer had stock.[1] (R. 21.)

The taxpayer, through its New York office, acted as buying agent for the various department stores which it served. In the great majority of cases, the taxpayer received purchase orders from those stores before it actually bought the goods. In these cases, the manufacturer or seller of goods purchased would invoice the proper department store directly for the goods so purchased. (R. 22.)

In some instances lots of merchandise of unusual value, in the judgment of the New York office, were purchased by the taxpayer without

[1] In one of those three, the taxpayer sold its stock to S. S. Kresge, who was a stockholder of the taxpayer (R. 21). The findings do not disclose whether S. S. Kresge similarly owned the stock in the fourth corporation, the Steinbach-Kresge store in Asbury Park, New Jersey (R. 21).

any previous request from any of the department stores it served. In such cases, invoices were made out to the taxpayer and the taxpayer re-invoiced the appropriate department store for the same at the same price; and passed on to the appropriate department store the discount allowed by the manufacturer or seller. (R. 22.)

In those instances where the manufacturers' or sellers' invoices ran to taxpayer, the shipping designation or direction to one of the department stores served was indicated or else the buying order indicated the designation of a particular department store (R. 22–23).

In addition to purchasing service, the New York office was on the alert for persons to fill executive positions in the stores the taxpayer was serving. This was done either with or without the request of any of such stores. Special attractions or exhibitions to draw persons into these stores were sought and obtained by the New York office and weak departments in the stores being served were surveyed and recommendations offered by the taxpayer through its New York office for their improvement. Taxpayer, through its New York office, consistently watched for new items, new departments, and special values in merchandise sold in the department stores it served through its New York office, and that office continually made recommendations about goods available for purchase

to those stores. Efforts were made to interest other stores in taxpayer's services and in a few instances these efforts were successful. (R. 23.)

The expenses of the New York purchasing office were totaled monthly, and once a month the various department stores which the taxpayer was serving were billed as follows: After deducting a fixed $100 per month payment to be made by the Steinbach-Kresge Company store at Asbury Park, New Jersey, the balance of the expenses was prorated among the other stores served by the taxpayer, according to the percentage which the annual sales of each such store bore to the total sales of all the stores for the prior year. (R. 23–24.)

The receipts and expenses of the New York City buying office of the taxpayer were thus equal (R. 24).

In its income tax return for 1935, the taxpayer reported total income of $156,429.18, including interest income in the amount of $93,889.98, and $61,720.73 as gross income received for services rendered by the New York office to the stores it thus served. In its return for 1936, it similarly reported total income of $96,277.05, including interest income in the amount of $63,406.45 and gross income in the sum of $32,759.48. (R. 24.) Thus, if the reimbursements for expenses which petitioner received from the stores it served were included in its gross income, petitioner would not

be a personal holding company under section 351 (b) (1) (A) because its income from dividends and interest would constitute less than 80% of its total gross income. The Board ruled that such reimbursements did constitute gross income and disapproved the Commissioner's determination of a deficiency based upon classifying petitioner as a personal holding company (R. 19–28). The court below, however, reversed the Board, holding that such receipts were not "gross income" (R. 107–111).

ARGUMENT

1. The decision of the court below is correct. Whether the taxpayer in this case comes within the statutory definition of a personal holding company depends upon whether the sums it received in exact reimbursement for expenditures previously made in behalf of certain department stores constituted gross income. The taxpayer entered into an informal arrangement (there was no written contract) whereby it maintained an office in New York and employed a number of people as buyers, whose duty it was to carry out specific buying orders for the various department stores in the group or to buy merchandise at advantageous prices which would be distributed among the group of stores and which would be billed to them without profit to the taxpayer and on the same terms granted to the taxpayer. The expenses of the taxpayer were prorated among

the department stores according to an agreed formula and were charged to the various department stores at the end of each month so that the taxpayer was reimbursed by the group of stores for the exact amount of its expenditures. Apparently expenses made in behalf of a particular store were billed to that store as service charges.

The Court below noted, adverting to the Board's findings, that the taxpayer was not a merchandising concern; neither was it in the business of performing services for compensation; rather it was a stockholding company and maintained the New York buying office solely for the purpose of increasing the value of its holdings (R. 110). The Board of Tax Appeals found that in a great majority of cases the taxpayer received purchase orders from the department stores before it actually bought the goods. In these cases the manufacturer or seller would invoice the proper department store directly for the goods so purchased. (R. 22.) The legal relationship between the taxpayer and the department stores in these instances would seem to be that of principal and agent. Therefore, whatever amounts the taxpayer spent as salaries for the buyers and clerks or as rent would seem to be the expenses of the principals, i. e., the department stores, not of the taxpayer. Since the taxpayer merely advanced money for its principals, reimbursement of those sums did not constitute income. See *All Russian Textile*

Syndicate, Inc. v. *Commissioner,* 62 F. 2d 614 (C. C. A. 2d), certiorari denied, 289 U. S. 752.

With respect to the other instances where the taxpayer bought merchandise without specific orders, but with the understanding that the stores would accept and pay for it without any profit to the taxpayer, we submit that the taxpayer acted as an agent with general powers, and that the relationship between the taxpayer and the department stores in those instances also was one of principal and agent. In the alternative we contend that when the taxpayer paid the expenses of the New York office, it was merely advancing funds for the various department stores in the group with the understanding that it would be repaid in the exact amount by the entire group of stores. Therefore, the sums received from the stores represented merely repayment of loans or advances.

The taxpayer maintains that the decision of the court below is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Wood* v. *Rasquin,* 97 F. 2d 1023, affirming *per curiam* 21 F. Supp. 211. In that case the taxpayer was a tenant in a co-operative apartment house and under the terms of the lease she was obliged to pay, in lieu of and as rent, her proportionate share of the aggregate amount of the cash requirements of the lessor for each year, including taxes and interest on the mortgage. She sought to deduct on her personal income tax re-

turn her share of the interest and her share of the taxes. The court held that only the lessor apartment house could deduct the interest and taxes, because the indebtedness for the taxes and interest was that of the lessor and not of the taxpayer. The facts of that case bear no resemblance to the facts of this case. No question was involved as to what constituted gross income; the question related to deductions. The court had no occasion to determine whether the rents received by the lessor constituted income because the lessor was not a party to the litigation.

The case of *Foley Securities Corp.* v. *Commissioner,* 106 F. 2d 731 (C. C. A. 8th), differs materially on its facts from the instant case.

2. Petitioner asserts a conflict (Pet. 6) with *Lane-Wells Co.* v. *Commissioner* (C. C. A. 9th), decided March 22, 1943, on the question whether the 25% penalty is applicable here by reason of petitioner's failure to file a personal holding company return on form 1120H. Although the *Lane-Wells* case held that the penalty cannot be imposed where the taxpayer, as here, has filed an ordinary corporation return on form 1120, the question is not presented by the decision of the court below. While it is true that the Commissioner originally asserted such a penalty (R. 10), the Board did not review the propriety of the penalty, for it had determined that the taxpayer was not a personal holding company. The court below merely re-

versed the Board on the question whether the taxpayer was a personal holding company; it did not pass upon the correctness of the penalty. The issue was neither discussed in any of the briefs filed in the court below, nor was it presented at the oral argument. The question will be open before the Board upon the determination of the petitioner's tax liability in accordance with the decision of the Circuit Court of Appeals.

If the decision of the Circuit Court of Appeals should be construed as approving the penalty, then this case would be, to that extent, in conflict with the *Lane-Wells* case, and certiorari would be appropriate, limited to that issue. But we think the issue was not passed upon by the court below and that there is no such conflict as calls for review by this Court.

CONCLUSION

The decision of the court below is correct and there is no conflict. The petition should be denied.

Respectfully submitted.

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SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
HELEN R. CARLOSS,
MORTON K. ROTHSCHILD,
Special Assistants to the Attorney General.

MAY 1943.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

* * * * *

(b) *Definitions.*—As used in this title—

(1) The term "personal holding company" means any corporation (other than a corporation exempt from taxation under section 101, and other than a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, and other than a life-insurance company or surety company) if—

(A) at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

> ART. 351–2. *Classification of a personal holding company.*—A personal holding company is defined as any corporation (other than a corporation specifically exempt), first, 80 percent or more of whose gross income for the taxable year was derived from royalties, dividends, interest, annuities, and gains from the sale of stock or securities; * * *.
>
> * * * * *
>
> The gross income for purposes of section 351 means the gross income as computed under sections 22, 204, and 231 and the articles thereunder, for purposes of the taxes imposed by Title I. Accordingly, items excluded from the gross income under Title I are not to be included in determining gross income under section 351. Gross income is not synonymous with gross receipts. For example, in the case of a sale or exchange of property, it includes only the excess of the amount realized therefrom over the adjusted basis provided for in section 113 (b). It does not include gains which are not recognized under section 112 (b). In the case of a corporation reporting on the installment basis, it includes only that portion of the gain returnable as income under section 44. In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining gross income, subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items

not ordinarily used in computing the cost of goods sold. Sales of capital assets as defined in section 117 must be treated as separate transactions and only those sales which individually resulted in profits shall be considered in determining the gains derived from such source. Gains from all transactions involving stock in trade, etc., are determined for the taxable year as a whole instead of separately.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1943

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JUN 1 1943
CHARLES ELMORE CROPLEY
CLERK

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 985.

KRESGE DEPARTMENT STORES, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR CERTIORARI.

REPLY BRIEF FOR PETITIONER.

The Circuit Court of Appeals expressly refused to determine whether there was a relationship of agent and principal between the petitioner and the corporations operating the various department stores (R. 110). Counsel for the respondent now renew the argument made below, that the petitioner was merely the agent of the department stores, and amounts spent in operating the New York City buying office were the expenses of the principal (Brief, p. 7). This argument is unsound. The stores did not, and were in no position to, control the detail of petitioner's daily operations; they could only commission petitioner to produce results by making purchases, obtaining special attractions, securing personnel, etc. Settled principles, expressed

as follows by Justice Brewer in *Casement* v. *Brown*, 148 U. S. 615, 622, are applicable:

> "Obviously, the defendants were independent contractors. * * * They selected their own servants and employees. Their contract was to produce a specified result. They were to furnish all the material and do all the work, and by the use of that material and the means of that work were to produce the completed structures. *The will of the companies was represented only in the result of the work, and not in the means by which it was accomplished.* This gave to the defendants the status of independent contractors, and that status was not affected by the fact that, instead of waiting until the close of the work for acceptance by the engineers of the companies, the contract provided for their daily supervision and approval of both material and work." (Italics added.)

All Russian Textile Syndicate, Inc. v. *Commissioner*, 62 F. (2d) 614 (C. C. A. 2nd), which was cited to the court below and is now cited here, should not be applied to the facts of this case. There the personal holding company statute was not involved. The taxpayer, a New York corporation, was a wholly owned subsidiary of a Russian organization. Among other things, it made purchases in this country for its parent, but the resemblance to the present case ends there. Goods were bought in the name of the subsidiary and there was originally an agreement by the parent to reimburse the subsidiary for the prices paid and for expenses of purchasing. From interest on bank deposits and from trading in cotton futures, the subsidiary obtained income. Then instead of carrying out the original agreement to reimburse for prices paid and expenses of buying, the

parent paid over to the subsidiary only enough to cover the balance left of those items after applying to them the earnings of the subsidiary from other sources. This was an obvious effort to eliminate the net income from interest and cotton futures which would otherwise have been shown; also an effort to pass along to Russia profits actually made in this country. The manipulation of the subsidiary's affairs to suit the parent organization, shows the degree of control which existed and the closeness of the relation. Because the court held on the facts before it that amounts paid by principal to agent were not a part of the agent's gross income and were actually costs of the principal for goods bought by it just as though it had acted without an agent, it does not follow that the decision applies to the much different facts of the present case.

Since the decision of the *All Russian Textile* case, the Circuit Court of Appeals for the same circuit has affirmed (memo. 97 F. (2d) 1023), *Wood* v. *Rasquin*, 21 F. Supp. 211, the cooperative apartment house case, which is cited and relied upon in the petitioner's main brief.

Respectfully submitted,

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